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FED RAISES RATE, SIGNALS MORE TO COME

The FOMC voted to raise the Federal funds rate by 25 basis points to 0.75%-1.0% and maintain its current policy of reinvesting maturing assets in its portfolio. There was one dissent, by President of the Federal Reserve Bank of Minneapolis, Kashkari, who favored maintaining the existing level of the Fed funds rate.

The Fed's rate hike clearly indicates that the Fed is confident that the economic improvement will be sustained. We welcome such confidence.

Although the FOMC members made only minor changes to their economic and inflation forecasts and left unchanged their forecast that it would be appropriate to raise rates a total of three times in 2017--implying two more hikes this year--and three times in 2018, ***the Fed's official Policy Statement includes changes in its assessment of inflation that signal clearly the Fed's heightened vigilance against*** *rising inflation (see Chart 1).*

In the Policy Statement, the Fed said that inflation has moved closer to the Committee's 2 percent long-run objective; that it expects inflation will stabilize around 2% over the medium term; and that "The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal". It also notes that business investment has firmed.

The Fed's heightened vigilance against inflation is particularly important in light of *the fact that even with the policy rate increase, monetary policy remains extremely accommodative even though the Fed has virtually achieved its dual mandate.* Consider the following: the real Federal funds rate remains negative and the Fed's balance sheet bloated, even though the unemployment rate is at the Fed's estimate of full employment (the natural rate of unemployment) and inflation is nearing the Fed's target of 2% measured by the PCE deflator (and is above it measured by the CPI) (see Chart 2).

Labor market tightness and improving economic conditions are putting modest upward pressure on wages and prices. We believe these economic and inflation conditions, along with the possibility of fiscal and regulatory reforms that would stimulate economic growth, put the Fed in a difficult position.

What are the Fed's forecasts saying?

Real GDP. The FOMC members maintained the basic outline of its economic forecast in its March update, with the median member forecasting real GDP to grow 2.1% in 2017 and 2018 and 1.9% in 2019 (see Table 1). These projections of modest growth are actually slightly higher than its anemic 1.8% estimate of longer-run potential growth (see Chart 3). So the Fed has not changed its economic forecast even though it has acknowledged that surveys of consumer and business confidence have spiked and the possibility that fiscal reforms may stimulate growth. Insofar as fiscal proposals are at their early stage in the legislative process, the Fed's holding back on its economic forecast is understandable. Nevertheless, upward revisions in upcoming forecast updates could change the environment for the Fed's conduct of monetary policy.

Inflation. ***The Fed's heightened concern about inflation is warranted***. Tighter labor markets, an improving economy and higher inflationary expectations have begun to generate wage and price pressures. Based on the Fed's forecast that the unemployment

15 March 2017

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rate will fall below full employment, suggesting more wage pressures, and its forecast that real GDP will grow slightly faster than potential, suggesting less slack in the economy, ***the Fed's forecast that i****nflation will not rise above 2% is risky* (see Chart 4). Presumably it is based on the expectation that the stronger US dollar will continue to suppress import prices, and that wage and price-setting behavior remain muted.

More realistically, the Fed's *inflation forecast is based on hope than sound forecasting, and if the economy strengthens and labor markets tighten further--as we expect--inflation will rise above 2%.* What does it mean when the Fed says it will monitor actual and expected inflation developments relative to its symmetric inflation goal? We will find out if "monitor" means "tighten policy in response to" and if "symmetric" means the Fed will be just as intolerant of inflation above 2% as it has been accommodative when inflation has been a touch below 2%.

The dots. The FOMC's estimates of what it perceives to be the appropriate Fed funds rate path points to a very gradual rise that would slowly raise the Fed funds rate up to the rate of inflation by year-end 2018 (see Chart 4). Again, by historical standards, this implies sustained monetary accommodation. Moreover, the Fed's extremely accommodative policy currently puts the Fed distinctly behind the curve. We expect that the Fed will be hard-pressed to maintain such a gradual rate increase, and markets will begin to price in faster increases, particularly for 2018 when economic momentum is expected to build. But time will tell the meaning of the language used in the Fed's official Policy Statement.

Table 1: **FOMC's Summary of Economic Projections at its March meeting**

Percent

Variable	Median[1]				Central tendency[2]				Range[3]			
	2017	2018	2019	Longer run	2017	2018	2019	Longer run	2017	2018	2019	Longer run
Change in real GDP	2.1	2.1	1.9	1.8	2.0 - 2.2	1.8 - 2.3	1.8 - 2.0	1.8 - 2.0	1.7 - 2.3	1.7 - 2.4	1.5 - 2.2	1.6 - 2.2
December projection	2.1	2.0	1.9	1.8	1.9 - 2.3	1.8 - 2.2	1.8 - 2.0	1.8 - 2.0	1.7 - 2.4	1.7 - 2.3	1.5 - 2.2	1.6 - 2.2
Unemployment rate	4.5	4.5	4.5	4.7	4.5 - 4.6	4.3 - 4.6	4.3 - 4.7	4.7 - 5.0	4.4 - 4.7	4.2 - 4.7	4.1 - 4.8	4.5 - 5.0
December projection	4.5	4.5	4.5	4.8	4.5 - 4.6	4.3 - 4.7	4.3 - 4.8	4.7 - 5.0	4.4 - 4.7	4.2 - 4.7	4.1 - 4.8	4.5 - 5.0
PCE inflation	1.9	2.0	2.0	2.0	1.8 - 2.0	1.9 - 2.0	2.0 - 2.1	2.0	1.7 - 2.1	1.8 - 2.1	1.8 - 2.2	2.0
December projection	1.9	2.0	2.0	2.0	1.7 - 2.0	1.9 - 2.0	2.0 - 2.1	2.0	1.7 - 2.0	1.8 - 2.2	1.8 - 2.2	2.0
Core PCE inflation[4]	1.9	2.0	2.0		1.8 - 1.9	1.9 - 2.0	2.0 - 2.1		1.7 - 2.0	1.8 - 2.1	1.8 - 2.2	
December projection	1.8	2.0	2.0		1.8 - 1.9	1.9 - 2.0	2.0		1.7 - 2.0	1.8 - 2.2	1.8 - 2.2	
Memo: Projected appropriate policy path												
Federal funds rate	1.4	2.1	3.0	3.0	1.4 - 1.6	2.1 - 2.9	2.6 - 3.3	2.8 - 3.0	0.9 - 2.1	0.9 - 3.4	0.9 - 3.9	2.5 - 3.8
December projection	1.4	2.1	2.9	3.0	1.1 - 1.6	1.9 - 2.6	2.4 - 3.3	2.8 - 3.0	0.9 - 2.1	0.9 - 3.4	0.9 - 3.9	2.5 - 3.8

Source: Federal Reserve

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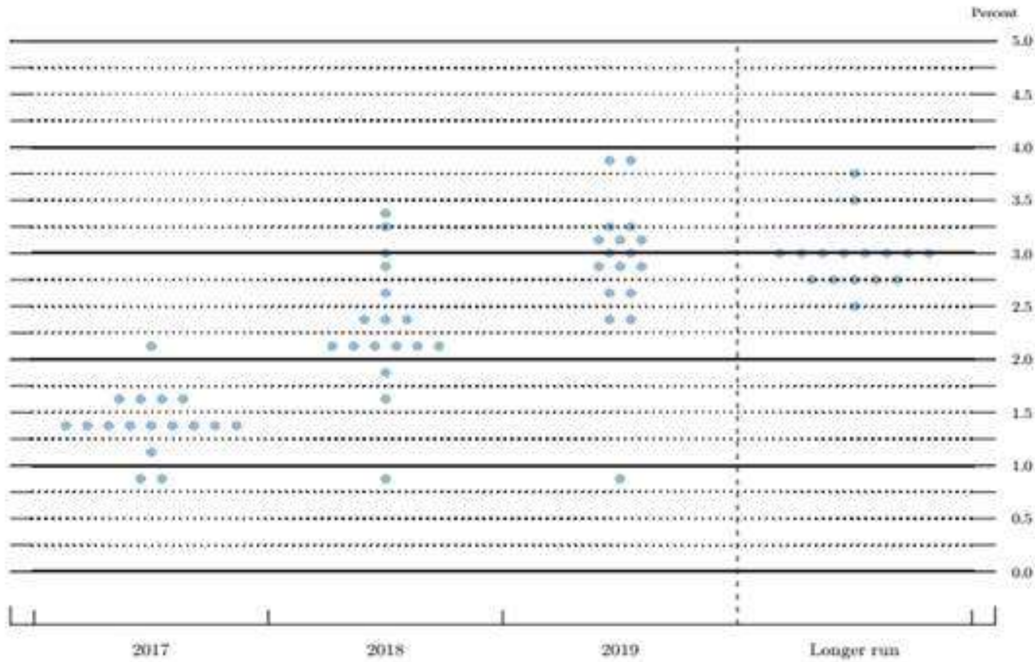
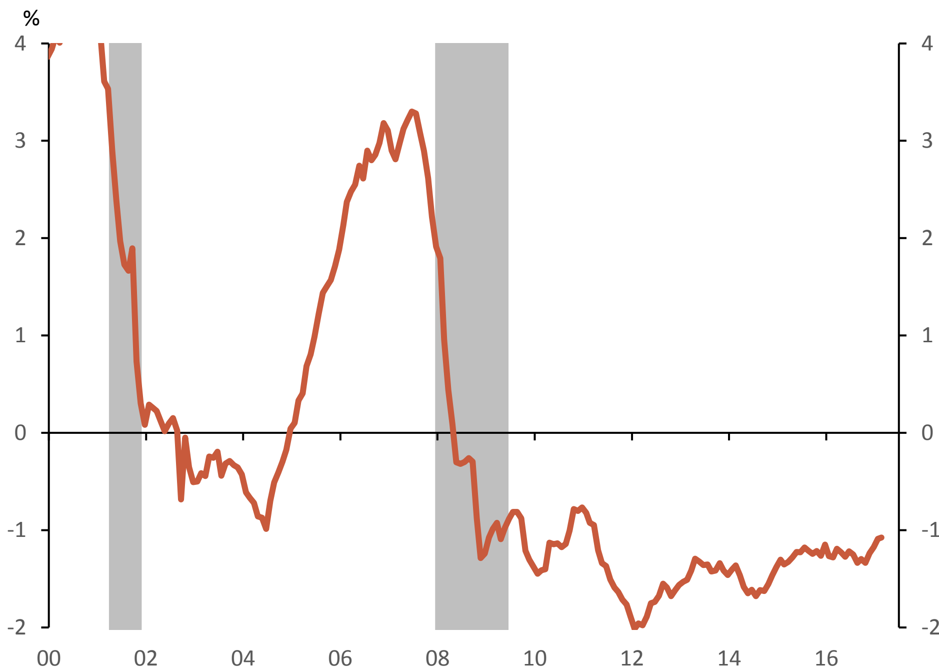
Chart 1: FOMC forecasts for the target for the federal funds rate



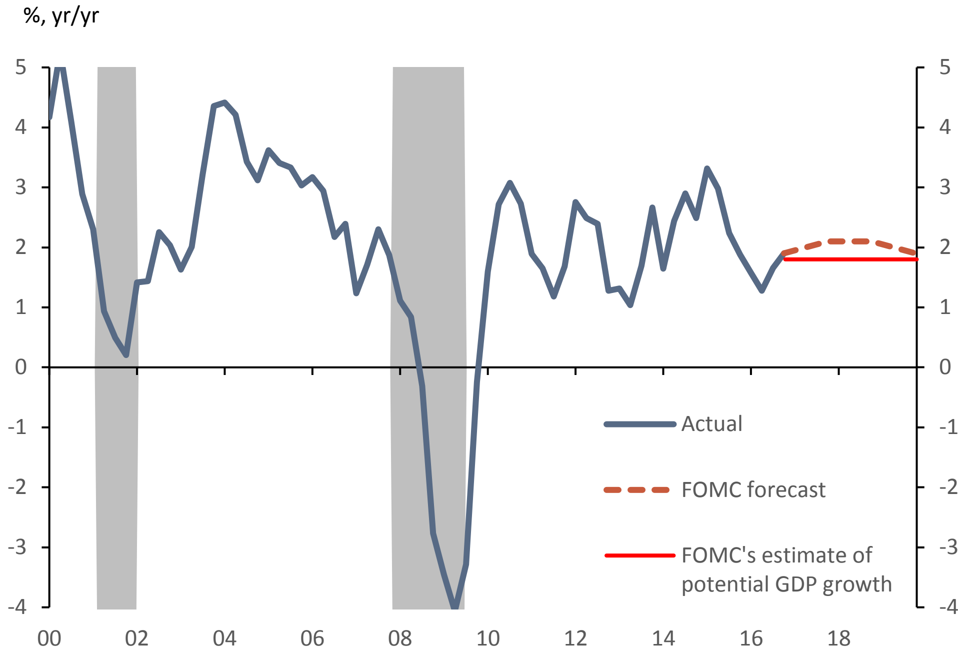
Source: Federal Reserve

Chart 2: Real fed funds effective rate (deflated by core PCE)



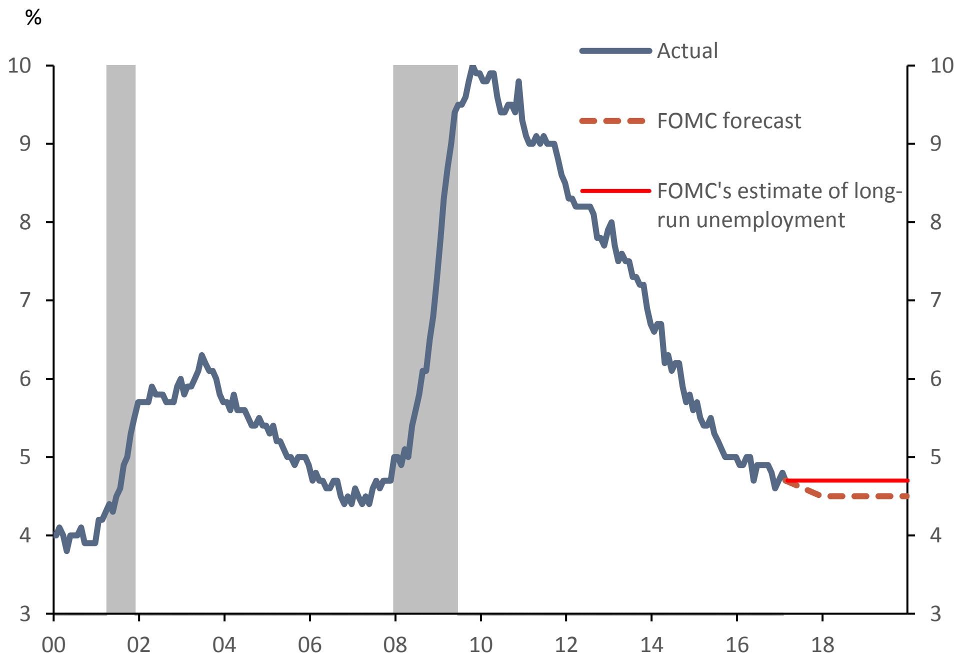
Source: Monthly data. Source: Federal Reserve, Bureau of Economic Analysis and Berenberg Capital Markets

Chart 3: Real GDP growth, actual and FOMC forecasts



Source: Quarterly data. Source: Federal Reserve, Bureau of Economic Analysis and Berenberg Capital Markets

Chart 4: Unemployment rate, actual and FOMC forecasts



Source: Monthly data. Source: Federal Reserve, Bureau of Labor Statistics and Berenberg Capital Markets

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